Office of Chief Counsel
Internal Revenue Service
memorandum
CC:LM:F:HAR:POSTF-167298-01
CJSantaniello

date: JAN 16 2002

to: [redacted], Team Manager, Waterbury, CT
Attn: [redacted], Revenue Agent

from: Associate Area Counsel (Financial Services) Area 1

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subject: [redacted] - **Captive Insurance Issue**

This is an interim response to your request for assistance regarding the captive insurance issue. As you indicated on December 11, 2001, the facts are not yet fully developed, as you are awaiting additional IDR responses from the taxpayer. During our conversation, I also suggested some additional questions not yet posed to the taxpayer.

As we also discussed, the known facts set forth in your December 11 memorandum are somewhat unclear. In an effort to facilitate our subsequent advice in this case, as well as identify additional areas requiring factual development, I have attempted to clarify the known, pertinent facts. In places where the stated facts remain unclear or incomplete, I have underlined the confusing passages to identify areas that require clarification or additional inquiries. I have also summarized the applicable law relating to captive insurance transactions, which you may also find useful in developing the facts. Additionally, I have prepared a list of factors that the courts have considered in addressing the captive insurance issue.

Issue

Whether payments made by [redacted] to [redacted], its wholly-owned subsidiary, for worker's compensation, product liability, and general liability insurance for all entities in the consolidated and affiliated group constitute "insurance" premiums deductible under I.R.C. § 162(a). **U.I.L. No. 162.04-03**

Facts

[redacted] ([redacted]) is a worldwide [redacted] company with [redacted] technologies and [redacted] production facilities. For the years [redacted], [redacted], and [redacted], it was the common parent of a consolidated group, and filed consolidated Forms 1120 for those years. On [redacted], [redacted]'s directors announced their approval of a merger with the [redacted]. The merger was consummated in [redacted].

On [redacted], [redacted] incorporated [redacted] as a wholly-owned subsidiary under the laws of [redacted]. [redacted] (b)(5)(AC) [redacted] (b)(5)(AC) Thereafter, on [redacted], [redacted] changed its name to [redacted] ([redacted]). [redacted] (b)(5)(AC) During all relevant time periods, [redacted] was a non-life insurance company and held a Class 3 license under the Insurance Act of 1978 (is this a U.S. or [redacted] statute?) and related regulations. [redacted] (b)(5)(AC) [redacted] , , (b)(5)(AC)

Under current [redacted] law, [redacted] is exempt from income tax on both operating income and capital gains. Under an understanding with [redacted]'s Minister of Finance, [redacted]'s income tax exemption will continue through the year [redacted].

[redacted] is neither regulated as an insurance company by the United States[1] nor taxed as an insurance company under subchapter L of chapter 1 of the Code. During [redacted], [redacted] made a retroactive election, to [redacted], under section 953(d) to be treated as a domestic insurance company for United States federal tax purposes. Under this election, [redacted] is subject to U.S. taxation on its worldwide income as if it were a U.S. corporation.[2]

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[1] Generally, the United States does not regulate insurance companies, which is left to the individual states under the McCarren-Ferguson Act.

[2] This election enables taxpayers to avoid Subpart F income. Additionally, the Code offers favorable tax treatment for small insurance companies offering life and property and casualty insurance. Generally, insurance companies earn money in two ways. First, they earn premium income through the sale of policies. Second, they earn investment income by investing their funds. A property and casualty insured that has direct and net premium income less than or equal to $350,000 can be tax exempt under section 501(c)(15). A property and casualty company with direct and net premium income greater than $350,000 but less than or equal to $1.2 million can elect to be taxed on only its investment income.

Until the [redacted], [redacted] insured risks for only [redacted], providing international property and casualty insurance for its parent. [redacted] , (b)(5)(AC) [redacted] , (b)(5)(AC) [redacted]? Thereafter, [redacted] expanded the types of coverage it provided to [redacted]. [redacted] , (b)(5)(AC) [redacted]? [redacted] also began to offer insurance coverage of all types to related and unrelated third-party insureds. [redacted] (b)(5)(AC) [redacted]

, (b)(5)(AC) [redacted]

, (b)(5)(AC) [redacted]

The policies issued to [redacted] and other members in the consolidated group accounted for approximately [redacted]% of the net premiums received by [redacted] in [redacted]. Due to the impending merger between [redacted] and [redacted], however, this percentage dropped to [redacted]% in [redacted]. , (b)(5)(AC) [redacted]

, (b)(5)(AC) [redacted]

, (b)(5)(AC) [redacted]

(b)(5)(AC) [redacted]

, (b)(5)(AC) [redacted]

During [redacted] through the merger, [redacted]'s day-to day operations were managed by [redacted] ([redacted]) [redacted] ([redacted]), which has [redacted] directors and [redacted] officers. [redacted] satisfies the Insurance Act's requirement that a principal representative in [redacted] be appointed ((b)(5)(AC) [redacted]) and that a principal office be maintained there. Also, as required by the Insurance Act, [redacted] directors and [redacted] officers reside in [redacted]. (b)(5)(AC) [redacted]

, (b)(5)(AC) [redacted]

, (b)(5)(AC) [redacted] After the merger with [redacted], the underwriting authority at [redacted] was transferred to The [redacted]. . (b)(5)(AC) [redacted] . (b)(5)(AC) [redacted]. Additionally, at that time, many policies issued by [redacted] were either cancelled or transferred to [redacted]'s own captive insurance company. [redacted] , (b)(5)(AC) [redacted]

During the examination, [redacted] was asked to identify the third parties for whom [redacted] provided insurance. A partial list of these third parties includes some of their related entities, such as partnerships and controlled foreign affiliates. These include:

[redacted]

, (b)(5)(AC) [redacted]

For [redacted] and its affiliates, [redacted] agreed to provide coverage of $[redacted] per occurrence and $[redacted] in the aggregate for worker's compensation risks, and property and business interruption coverage of $[redacted] per occurrence, excess of deductibles. For unrelated policyholders, [redacted] agreed to provide coverage for the first $[redacted] on general liability and workers' compensation risks, and $[redacted] on automobile and employers' liability. Although it is not entirely clear, it appears that these coverage limits were applicable on a per occurrence basis. , (b)(5)(AC) [redacted]
, (b)(5)(AC) [redacted]

During [redacted] through [redacted], [redacted] provided the following coverage to [redacted]:

(1) [redacted] issued a [redacted] policy, effective [redacted], extended for an additional [redacted] during [redacted], covering:

(a) $[redacted] per occurrence of [redacted]'s property and business interruption risks, excess of an underlying retention of $[redacted] which is excess of deductible,

(b) $[redacted] per occurrence of their general liability coverage excess of an annual retention of $[redacted] excess of $[redacted], and

(c) The policy period aggregate is $[redacted] and policy term aggregate is $[redacted].

These policies are [redacted]% reinsured with a single reinsurer. Is [redacted] , (b)(5)(AC)

(2) Regarding excess liability coverage for [redacted], [redacted] has written a [redacted] policy, effective [redacted], for $[redacted] excess of $[redacted] of the excess liability risks of [redacted] and affiliates. These risks are also [redacted]% reinsured with a single reinsurer. [redacted] , (b)(5)(AC) [redacted] (b)(5)(AC) ?

(3) For [redacted], [redacted] has written a [redacted] property coverage policy, effective [redacted], for $[redacted] excess of $[redacted] per occurrence, and $[redacted] in the aggregate for the [redacted] and $[redacted], excess of $[redacted] per occurrence and $[redacted] in the aggregate for the [redacted], and a [redacted] casualty coverage for $[redacted] excess of $[redacted] per occurrence and $[redacted] in the aggregate. These risks are [redacted]% reinsured with a single reinsurer. [redacted] , (b)(5)(AC) ?

[redacted] also wrote a multi-year policy covering property and casualty from [redacted]. The property limit is $[redacted] per occurrence, excess of $[redacted]. The liability limit is $[redacted] per occurrence, excess of $[redacted]. These risks are [redacted]% reinsured by various reinsurers. [redacted] , (b)(5)(AC) [redacted] , (b)(5)(AC) ?

[redacted] has written an excess liability policy of $[redacted] per occurrence and in the aggregate excess of $[redacted] per occurrence and in the aggregate. These risks are also [redacted]% reinsured with a single reinsurer. [redacted]?

[redacted] also wrote a [redacted] excess liability policy for [redacted], a partnership in which [redacted] is [redacted]% partner. The limit on this policy is $[redacted] per occurrence and in the aggregate excess of $[redacted] per occurrence and in the aggregate. These risks are [redacted]% reinsured by [redacted] insurers. There is also a number of other policies written or assumed by [redacted] for primary and excess layers of coverage. , (b)(5)(AC) [redacted]? None of these policies are individually greater than [redacted]% of the total premiums written and assumed in [redacted]. (b)(5)(AC) [redacted] , (b)(5)(AC) [redacted]?

[redacted]

, (b)(5)(AC) [redacted]. [redacted] reinsured [redacted] workers' compensation liability, general liability, and auto liability coverage of [redacted]. , (b)(5)(AC) [redacted]? Under these policies, [redacted] is responsible for up to and including $[redacted] of each incurred loss. [redacted]? This policy is written for [redacted] from [redacted]. , (b)(5)(AC) [redacted]?

[redacted] deposited $[redacted] to the reinsurer. , (b)(5)(A [redacted] , (b)(5)(AC) [redacted] , (b)(5)(AC) [redacted] The deposit bears interest at a rate equal to the

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[3] It is possible that this involves a type of retro-rated policy. Under such an arrangement, the reinsurer agrees to provide certain coverage to the insurer ([redacted]) up to a specified amount. But, if claims made against the reinsurer do not exceed that amount, part of the premium is returned to the insurer.

Another possibility is the existence of a "fronting agreement" between [redacted] and an unrelated US insurance company, the fronting company. Under this type of arrangement, it is prearranged that all or substantially all of the risk assumed by the fronting company will be immediately reinsured, often with an yield on the one-year United States Treasury Bill on the date paid. This interest accrues to [redacted]'s benefit, and, as such, is not reflected in [redacted]'s financial statements. Under the agreement, the deposit should have been returned to [redacted] in full on [redacted], providing no losses were ceded to the reinsurer. Unpaid claims paid to [redacted]. [redacted] (b)(5)(AC) ? To date, this deposit is still outstanding.

During [redacted] and [redacted], [redacted] paid investment management fees of $[redacted] for [redacted] and $[redacted] for [redacted] to [redacted] ([redacted]), another [redacted] subsidiary. [redacted] (b)(5)(AC) ? Under the terms of the investment management agreement, [redacted] is entitled to a quarterly fee at an annual rate of [redacted]% of the market value of assets under management subject to a minimum annual fee of $[redacted]. [redacted] also pays an annual management fee to [redacted] of $[redacted]. [redacted] (b)(5)(AC) ?

[redacted] (b)(5)(AC)

Premiums written or assumed are recorded on the accrual basis and are included in income on a pro-rated basis over the term of the underlying contract with the unearned portion deferred in the balance sheet. Reinsurance premiums ceded are similarly pro-rated over the terms of the contracts with the unearned portion being deferred in the balance sheet as prepaid reinsurance premiums.

Acquisition expenses, mainly commissions and brokerage fees, related to unearned premiums are deferred and amortized to income over the periods in which the premiums are earned. The method

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offshore company effectively controlled by the insured (here, [redacted]). The insured will then claim a deduction for the premium paid to the U.S. insurer. Ordinarily, however, the U.S. insurer would not be entitled to deduct the reinsurance premiums paid to the foreign insurer ([redacted]) under state regulations unless there is some guarantee that there will be funds available to pay claims. To solve this problem, the parties will sometimes establish some type of escrow account to hold the funds paid to the reinsurer ([redacted]). Although the funds belong to the reinsurer, the U.S. insurer also retains control over the funds to satisfy claims.

followed in determining the deferred acquisition expenses limits the amount of the deferral to its realizable value by considering losses and expenses to be incurred as premiums are earned.

[redacted] has issued, through its [redacted] bank, letters of credit totaling $[redacted] ([redacted] - $[redacted]) in favor of the ceding insurance companies. [redacted]. On [redacted], fixed interest securities with a fair value of $[redacted] ([redacted] - $[redacted]) were pledged as collateral for these letters of credit. , (b)(5)(AC) [redacted]?

During taxable years [redacted] and [redacted], [redacted] had a risk financing cash flow arrangement with [redacted] ([redacted]) with respect to a premium payment plan for certain insurance policies. Those policies are identified in the "Policy Summary" provided by [redacted]. , (b)(5)(AC) [redacted]

According to its books and records, [redacted] is required and does pay monthly advanced premiums to [redacted] and other insurance brokers and carriers. [redacted] agrees to maintain, on account, certain escrow balances previously agreed to by [redacted]. The source of such escrow balances comes from the premium paid by [redacted] to [redacted] under the plan or policy, after withholding for certain expenses. [redacted] , (b)(5)(AC) [redacted]?

It was further agreed that funds on deposit would be in the name of the carrier. However, upon termination of this agreement either by mutual consent or when all losses arising from the insured years have incurred, any funds remaining in the account will immediately be paid back to the policyholder ([redacted]) provided that all obligations to [redacted] have been satisfied. , (b)(5)(AC) [redacted] , (b)(5)(AC) [redacted]

Under the "Policy Program", [redacted] would administer the advanced premium paid in by [redacted] to satisfy the following expenses:

(a) Variable expenses.

(b) Fixed expenses (including state taxes). Excess Premiums. This covers all excesses per claim for workmen's compensation and general product liability and auto, respectively

(c) Loss Amounts. This represents actual limited loss payments made by the agent company on behalf of [redacted]. Such amounts shall continue to be withheld from the advanced premium until the amount of outstanding limited incurred loss, as determined by ([redacted] and the insurance carrier for that state,) is equal to or less than the Escrow amount.

(d) Escrow Amount. Based upon the available information, it is the examining team's contention that the Escrow Amount is maintained to pay all future claims, subject to dollar limitations, arising out of the policy year covered. In addition, the Escrow Account allows the agent company to withdraw funds to satisfy charges for fixed and variable expenses and excess premiums at the final premium determination.

, (b)(5)(AC) [redacted]?

Discussion

Generally, premiums paid for insurance are deductible under section 162(a) if directly connected with the taxpayer's trade or business. Treas. Reg. § 1.162-1(a). Although the Internal Revenue Code does not define the term "insurance", the United States Supreme Court has explained that to constitute "insurance", a transaction must involve "risk shifting" and "risk distribution". Helvering v. Le Gierse, 312 U.S. 531, 539 (1941). "Risk shifting means one party shifts his risk of loss to another, and "risk distributing" means that the party assuming the risk distributes his potential liability, in part, among others. Beech Aircraft Corp. v. United States, 797 F.2d F.2d 920, 922 (10th Cir. 1986).

It is well settled that amounts set aside as a self-insurance reserve for anticipated losses are not deductible insurance expenses because risk is not shifted from the taxpayer. Carnation Co. v. Commissioner, 640 F.2d. 1010, 1013 (9th Cir. 1981); Steere Tank Lines, Inc. v. United States, 577 F.2d 279, 280 (5th Cir. 1978), cert. denied, 440 U.S. 946 (1979); Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78, 79 (10th Cir. 1930), cert. denied, 284 U.S. 654 (1931); Harper Group v. Commissioner, 96 T.C. 45, 46 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992). Therefore, these amounts are not deductible until the taxpayer actually pays or accrues the anticipated loss. United States v. General Dynamics Corp., 481 U.S. 239, 243-244 (1987); Harper Group, 96 T.C. at 46 n2.

In between the extremes of ordinary insurance and direct self-insurance lies the captive insurance transaction. Clougherty Packaging Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Harper Group, 96 T.C. at 46 (captive transactions "straddle the fence between ordinary insurance and self-insurance."). A captive insurance company is a corporation organized for the purpose of insuring the liability of its owner. Harper Group, 96 T.C. at 46 n3. Issues of risk shifting and risk distribution arise where the insured is the sole shareholder of the captive insurer or the owners are its (the captive's) only insureds.

In cases where the taxpayer enters into an insurance arrangement with a related insurance company, both the Service and the courts have attempted to address whether sufficient risk shifting is present in order for the transaction to be considered insurance. The earliest pronouncement on the issue of captive insurers came from the Service in Rev. Rul. 77-316, 1977-2 C.B. 53. Clougherty, 811 F.2d at 1301. In it, the Service reviewed three hypothetical situations involving a wholly-owned captive that provided insurance to only its parent and affiliates - in one case directly and in the others through an unrelated intermediate insurer. In Situation 2 of Rev. Rul. 77-316, the Service concluded that an arrangement in which a wholly-owned subsidiary "insures" only its parent and related companies, whether directly or through an unrelated third party as a reinsurer, is not insurance.

In concluding that there is no economic shifting of risk between parent and captive insurance subsidiary in Rev. Rul. 77-316, the Service relies on what has been come to be known as the "economic family" concept.

> [T]he insuring parent corporation and its domestic subsidiaries, and the wholly-owned 'insurance' subsidiary, though separate corporate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss... Because [premiums] remain within the economic family and under the practical control of the respective parent in each situation, there has been no amount 'paid or incurred'.... [N]othing has occurred other than a movement of an asset (cash) within each family or related corporations.

Id. at 54-55. The ruling states that the application of the economic family theory recognizes the separate tax status of subsidiary corporations, as required by Moline Properties, Inc.

v. Commissioner, 319 U.S. 436 (1943), "but also examines the economic reality of each situation described." Rev. Rul. 77-316 at 55.

In Rev. Ru. 88-72, 1988-2 C.B. 31, the Service clarified Rev. Rul. 77-316, emphasizing that the result would not change even if the wholly-owned insurance subsidiary insured unrelated third parties. See Mobile Oil Corp. v. United States, 8 Cl. Ct. 555 (1985) (deduction disallowed even though third-party insurance represented a majority of the captive's business). But see Gulf Oil Corp. v. United States, 89 T.C. 1010, 1027 (1987) (dictum). In Rev. Rul. 88-72, however, the Service announced that it will not follow the dictum in Gulf Oil to the extent that it suggests that the presence of third-party insureds might under certain circumstances produce the requisite risk shifting.

The facts in Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981) are identical to those in Situation 2 in Rev. Rul. 77-316.[4] In that situation, the parent purchased blanket insurance from an unrelated insurance carrier, which then reinsured 90% of its liability under the policy with the parent's wholly-owned Bermuda subsidiary. In accepting this arrangement, however, the insurer required the parent to agree to increase at the insurer's request the subsidiary's capitalization, which at the time was substantially less than the annual premium ceded to the subsidiary. The captive did not provide coverage for anyone other that its parent and the parent's subsidiaries. The Service denied the deduction for $1,755,000 (90% of $1.95 million) based on the economic family theory.

In Carnation, the Tax Court refused to adopt the Service's economic family argument. Carnation v. Commissioner, 71. T.C. 400, 413 (1978). Nevertheless, it held that the premiums, to the extent they were ceded to the captive insurance subsidiary, were not deductible because the risk as to that percentage had not been shifted from the parent. Id. at 409-410. According to the Tax Court, the Le Gierse risk shifting and risk distribution requirements were ample precedent for its holding. 71 T.C. at 410. The Tax Court opinion did not mention Rev. Rul. 77-316. The court's holding has been described as an extension of the general rule that reserves set aside to cover a future contingency are not currently deductible. Sears, Roebuck & Co. v. Commissioner, 96 T.C. 61, 97 (1991), aff'd 972 F.2d 858 (7th Cir. 1992).

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[4] This case presented the first judicial review of the captive insurer question. Clougherty at 1302.

On appeal, the Ninth Circuit, citing the risk shifting requirement and the nondeductibility of self-insurance reserves, held that there was no insurance based on the substance of the arrangement. Id. at 1013. According to the court, "[t]he Tax Court's holding as a matter of law that these agreements neutralize the risk to the extent...[the unrelated insurer] reinsured with...[the captive] is correct." Id. After noting its agreement with the Tax Court that the facts presented a classic case of transactions which should have been recharacterized to reflect economic substance, the Ninth Circuit re-opened the technical tax issue by discussing, and approving, Rev. Rul. 77-316, which was not mentioned in the Tax Court opinion. The court also stated that its holding did not conflict with recognition of the separate status of corporations. Id. See also Beech Aircraft, 797 F.2d at 923 n2 ("By examining the substance of the transaction between [the parent] and [the captive], we do not disregard the separate nature of the entities, rather we seek to determine whether the requisite elements of an insurance contract are present.").

Over the next ten years, the Tax Court continued to reject the economic family theory.[5/] At the same time, the theory was accepted by the Ninth Circuit (again),[6/] by two federal district courts,[7/] and by the Court of Claims.[8/] The recharacterization

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[5/] Gulf Oil Co. v. Commissioner, 89 T.C. 1010, 1024 (1987); Humana, Inc. v. Commissioner, 88 T.C. 197, 214 (1987); Clougherty Packaging Co. v. Commissioner, 84 T.C. 948 (1985); Americo v. Commissioner, 96 T.C. 18, 41 (1991); Harper Group v. Commissioner, 96 T.C. 45, 57 (1991); Sears, Roebuck & Co. v. Commissioner, 96 T.C. 61 (1991).

[6/] Clougherty Packaging Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987).

[7/] Stearns-Roger Corporation v. United States, 577 F. Supp. 833 (D. Colo. 1984), aff'd 774 F.2d 414 (10th Cir. 1985); Beech Aircraft Corp. v. United States, 84-1 U.S.T.C. ¶ 9803 (D. Kan. 1984), aff'd 797 F.2d 290 (10th Cir. 1986).

[8/] Mobile Oil Corp. v. United States, 8 Cl. Ct. 555 (1985).

analysis was followed by the Tax Court on four occasions[9] and by the Sixth Circuit.[10]

In Stearns-Roger Corp. v. United States, 774 F.2d 414 (10th Cir. 1985), the parent made premium payments to its captive insurance subsidiary. All of the subsidiary's stock was owned by the parent and one of its (the parent's) wholly-owned subsidiaries. The parent provided all capital to the subsidiary, and also agreed to indemnify the subsidiary up to $3 million for losses it might suffer. Although no occasion arose to use the indemnity agreement, it was in effect throughout the entire four-year period in question.

The court held that the premium payments were not deductible under section 162(a) because the risk of loss did not leave the parent.[11] Id. at 415, 417. The Tenth Circuit found no substantial difference between the facts in Stearns-Roger and those in Carnation. Id. at 416. According to the court, the arrangement was in substance self-insurance:

> The reality of the transaction has to be recognized. The comparison of the arrangement here made to self-insurance cannot be ignored. The parent provided the necessary funds to the subsidiary by way of what it called 'premiums' to meet the casualty losses of the parent. The subsidiary retained these funds until paid back to the parent on losses. This does not appear to have different consequences than did the [reserve] payments in Spring Canyon Coal Co. v. Commissioner, 43 F.2d 78 (10th Cir. 1930).

Id. at 416. It appears that the Tenth Circuit rested its holding impliedly if not expressly on the economic family theory. See Humana, Inc. v. Commissioner, 881 F.2d 247, 252 (6th Cir. 1989). The court further held that its conclusion regarding the lack of risk shifting was not inconsistent with the separate corporate identity concept in Moline Properties.

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[9] Gulf Oil Co. v. Commissioner, 89 T.C. 1010 (1987); Humana, Inc. v. Commissioner, 88 T.C. 197 (1987); Clougherty Packaging Co. v. Commissioner, 84 T.C. 948 (1985); and Carnation Co. v. Commissioner, 71 T.C. 400 (1978).

[10] Clougherty Packaging Co. v. Commissioner, 881 F.2d 247 (6th Cir. 1989).

[11] The Tenth Circuit did not consider the indemnification agreement in its analysis.

In Beech Aircraft Corp. v. United States, 84-1 U.S.T.C. ¶ 9803 (D. Kan. 1984), aff'd 797 F.2d 290 (10th Cir. 1986), the taxpayer formed a captive insurance subsidiary for legitimate business reasons (i.e., to have more control over the defense of product liability claims). Thereafter, it obtained its products liability coverage with the newly-formed, but not wholly-owned subsidiary. All but .5 percent of the insurer's business was insurance issued to its parent. During the year in question, the taxpayer made premium payments equal to the discounted value of the full amount of coverage offered by the captive. In other words, the premium for $2 million of coverage was $1,675,000 ($2 million less the anticipated interest that would be earned on that sum). Although the captive issued the policy covering the taxpayer's products liability of $2 million, it was capitalized with only $150,000.

Foregoing the more obvious recharacterization and sham transaction theories, the Tenth Circuit relied on the economic family theory, citing its earlier holding in Stearns-Rogers. 797 F.2d at 923. According to the court, Stearns-Roger "bears directly on" and "for all practical purposes, is dispositive of" the case before the court. Id. The court assessed the economic reality of the transaction and determined that the parent paid for any losses sustained by the captive and that no shifting of risk had occurred. The court further held that the separate corporate status of the parent and its subsidiary did not prevent a finding that risk of loss did not shift. Id. The court did not discuss the effects of the subsidiary's unrelated business.

Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), involved a wholly-owned subsidiary incorporated in Colorado under state captive insurance laws. The parent purchased worker's compensation insurance from an unrelated insurer, which then reinsured the first $100,000 of each claim against the parent with the captive subsidiary insurer. The captive's only business was reinsurance of the parent company.

In Clougherty, the Tax Court once again rejected the government's economic family argument in favor of a straight recharacterization approach. 84 T.C. at 959. According to the court,

> We found in Carnation, as we find here, that to the extent the risk was not shifted, insurance does not exist and the payments to the extent are not insurance premiums. The measure of the risk shifted is the percentage of the premium not ceded. This is nothing more than a recharacterization of the payments which [the taxpayer] seeks to deduct as insurance.

Id. at 959 (emphasis in original). The court also reaffirmed its holding in Carnation that the holding of Le Gierse applies regardless of whether the parent and captive subsidiary were considered separate entities for tax purposes. Id. The court also declined to decide how the result might be affected if the captive had insurance business from unrelated customers. Id. at 960.

Although the Tax Court in Clougherty based its opinion on economic substance, the Ninth Circuit once again relied on the economic family theory, this time making it clear that the theory was the basis (and should have been the Tax Court's basis) for its holding. The court's position is well illustrated by the following passage:

> Evidently, the Tax Court below sensed a tension between the economic family concept and Moline Properties. It expressed concern that the concept 'might foster a theory which would be extended to other areas of the tax law.' (citation omitted) The [Tax Court], however, found it unnecessary to use the term 'economic family' in deciding the case because it could be decided 'within the parameters of Carnation. (citation omitted) Given that our holding in [Carnation] ...explicitly refers to [Rev. Rul. 77-316], it seems odd that the Tax Court uses Carnation as a means of avoiding reliance on the Ruling.

Id. 1302.

The next development in the line of captive insurance cases involved sibling corporations. In Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989), a case of first impression, a wholly-owned captive directly insured both its parent's and its (the captive's) sibling's risks. The parent made all premium payments, but filed a consolidated return in which it charged the sibling subsidiaries with the premium payments it made on their behalf. Premiums were calculated by standard industry practices and there was no agreement to assure the captive's ability to meet its obligations beyond an initial capital contribution. The parent owned 75% of the captive's stock, with the remaining 25% owned by one of the parent's other subsidiaries.

In Humana, the Tax Court distinguished two separate issues: first, the core issue of the deductibility of premiums paid to the captive for coverage of the parent's risks (described as the parent-subsidiary issue), and second, the charge-back by the parent to those sibling subsidiaries for which the parent had paid for coverage from the captive (described as the brother-sister issue). 88 T.C. at 206.

Regarding the parent-subsidiary issue, the court followed its holdings in Carnation and Clougherty, both of which had already been upheld on appeal. Id. at 207. Regarding the brother-sister issue, the Tax Court extended the risk-shifting analysis applied in Carnation and Clougherty to premiums paid to a sibling captive insurer. Id. at 213. The court reasoned that failing to extend its holdings in those cases to the brother-sister factual pattern would "exalt form over substance and permit a taxpayer to circumvent our holdings by simple corporate structural changes." Id.

On appeal, the Sixth Circuit in Humana affirmed the Tax Court on the parent-subsidiary issue, holding that under the principles of Carnation and Clougherty, premiums paid by a parent to a subsidiary did not constitute insurance premiums because the parent did not shift the risk of loss to the captive. 881 F.2d at 251.

Regarding the brother-sister issue, however, the court held that the Tax Court had incorrectly extended the rationale of those cases to the brother-sister context. Adopting the analysis in Clougherty, the court examined the effect of a claim on the assets of the insured. According to the court, when the insurer paid a claim, the assets of its siblings were not affected and, thus, the risk of loss transferred from the insured to the insurer. The court in Humana stated that it did not look to the assets of the parent because to do so would be to treat the parent, its subsidiaries, and the insurer "as one 'economic unit' and ignore the reality of their separate corporate existence for tax purposes in violation of Moline Properties." 881 F.2d at 256.

After finding that risk shifting had occurred, the Sixth Circuit stated that risk distributing was also present because the consequences of a loss were spread over a larger group than just those presented by the parent and the captive. Id. at 257. Thus, the court ruled that the premiums paid by the parent's subsidiaries constituted insurance because both risk shifting and risk distributing occurred. Id. The court concluded by asserting that"[u]nder no circumstances do we adopt the economic family argument advanced by the government." Id.

In Malone & Hyde v. Commissioner, 62 F.3d 835 (6th Cir. 1995), the Sixth Circuit applied Humana to a brother-sister insurance transaction and concluded that the captive insurer was a sham, and that the payments at issue were therefore not deductible as insurance premiums. In Malone, the taxpayer and its operating subsidiaries purchased insurance from a commercial insurer, which then reinsured a significant portion of those risks with the taxpayer's captive insurance subsidiary. The commercial insurer retained a portion of the premiums received from the parent, and paid the remainder to the captive subsidiary as a reinsurance premium. The taxpayer claimed deductions for the insurance premiums paid to the commercial insurer. In determining that the captive insurance company was a sham corporation, the court in Malone noted that the parent "propped up" the captive by guaranteeing its performance, the captive was thinly capitalized, and the captive was loosely regulated by the locale in which the captive was incorporated (Bermuda). Id. at 840.

In addition to the factors set forth in Malone, other factors considered in determining whether a captive insurance transaction is a sham include: whether the parties that insured with the captive truly faced hazards; whether premiums charged by the captive were based on commercial rates; whether the validity of claims was established before payments were made on them; and whether the captive's business operations and assets were kept separate from its parent's. Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728-729 (1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993).

The most recent captive cases have involved the presence of unrelated insureds. In Gulf Oil Corp. v. Commissioner, 89 T.C. 1010 (1987), aff'd 914 F.2d 396 (3d Cir. 1990), the U.S. taxpayer established a wholly-owned Bermuda captive insurance subsidiary. Through prearrangement, the parent, its affiliates, and various related corporations purchased insurance from commercial insurers which, in turn, reinsured the risk with the captive by ceding the premiums collected from the taxpayer and its affiliates to the captive. The adequacy of the captive's initial capitalization was questionable, and the parent executed guarantees to protect the fronting carriers. The captive also provided risk coverage to unrelated parties. While third-party coverage was only 2% of net premium income in 1975, it increased to 7% in 1976, 16% in 1977, 51% in 1978, 54% in 1979, and 63% in 1983. 88 T.C. at 1021-1022. However, only tax years 1975 and 1976 were before the Tax Court.

In Gulf Oil, the Tax Court considered whether the presence of unrelated risk allowed risk transfer and risk distribution to occur. 88 T.C. at 1025. The court recognized that risk transfer and risk distributing would occur if the premiums collected from related parties were not likely to cover their anticipated losses. Id. at 1027. The court declined, without expert testimony, to provide guidance as to how much unrelated risk was necessary to achieve this result. Id. at 1027 n14.[12] However, the court held that two percent was de minimis and could not produce risk transfer and risk distribution. Id. at 1028.

The Third Circuit affirmed, refusing to consider the affiliates and siblings as separate entities for the purpose of determining whether risk shifting and risk distributing had occurred. 914 F.2d at 412. The court reasoned that the captive had failed to establish itself as a separate entity for insurance purposes because it was undercapitalized and its parent had an ongoing obligation to guarantee the captive's ability to meet its reinsurance obligations. Id. The court viewed Humana as distinguishable on the basis that Humana did not involve an undercapitalized insurer or guarantees executed by the parent company.

The watershed in unrelated risk cases occurred in the Tax Court trilogy of Americo, Inc. v. Commissioner, 96 T.C. 18 (1991), aff'd 979 F.2d 162 (9th Cir. 1992), The Harper Group v. Commissioner, 96 T.C. 45 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992), and Sears, Roebuck & Co. v. Commissioner, 96 T.C. 61 (1991), aff'd 972 F.2d 858 (7th Cir. 1992). In each case, the court established a three-step analysis to determine if insurance exists in cases where the captive insurer provides risk coverage to parties unrelated to the parent or its affiliates. This analysis, based on Le Gierse, includes "presence of insurance risk", "risk shifting and risk distribution", and "commonly accepted notions of insurance".

Americo, Harper Group, and Sears involve captive insurers that underwrote approximately fifty, thirty, and ninety-nine percent unrelated risk, respectively. Amerco, 96 T.C. at 29; Harper Group, 96 T.C. at 59-60; Sears, 96 T.C. at 63. In each case, the court held that the captive insured enough unrelated risk to achieve risk distribution and risk shifting, and that the premiums paid were deductible. Amerco, 96 T.C. at 42; Harper Group, 96 T.C. at 60; Sears, 96 T.C. at 102. See also Ocean

[12] It did state, however, that "[i]f at least 50 percent are unrelated, we cannot believe that sufficient risk transfer would not be present." 89 T.C. at 1027 n.14.

Drilling & Exploration Co. v. United States, 988 F.2d 1135 (Fed. Cir. 1993) (held 44% and 66% were "within the range of unrelated business found by the Tax Court's decisions to constitute transfer of risk."). But compare Gulf Oil Corp. v. Commissioner, 89 T.C. 1010 (1987), aff'd 914 F.2d 39 (3d Cir. 1990) (risk distribution lacking where less than 2 percent of captive insurer's business comes from unrelated insureds).

The Tax Court did not, however, offer guidance as to the minimum threshold of unrelated risk that a captive needs to insure. Additionally, the significance of the two additional factors, apart from risk shifting and risk distributing, were not thoroughly explained. In Americo, the court cited the captive's utilization of standard industry practices and the fact that it was not domiciled in a foreign jurisdiction as key factors guiding its decision. 96 T.C. at 36-37. Yet, the fact that the captive in Harper Group was incorporated in Hong Kong did not appear to affect the court's analysis. Given the lack of deference to the additional factors, it seems safe to assume that absent outright fraud, the additional requirements of deductibility will be met.

No court, in addressing a captive insurance transaction, has fully accepted the "economic family" theory set forth in Rev. Rul. 77-316. Consequently, in Rev. Rul. 2001-31, 2001-26 I.R.B. 1348, the Service announced that it will no longer invoke the economic family theory with respect to captive insurance transactions. The Service further announced, however, that it will continue to challenge certain captive insurance transactions based on the facts and circumstances of each case, citing Clougherty Packaging (concluding that a transaction between parent and subsidiary was not insurance) and Malone & Hyde v. Commissioner, 62 F.3d 835 (6th Cir. 1995) (concluding that brother-sister transactions were not insurance because the taxpayer guaranteed the captive's performance and the captive was thinly capitalized and loosely regulated).

Rev. Rul. 2001-31, therefore, reflects the Service's efforts to be consistent with established case law. Although the ruling does not discuss the Service's position regarding situations where the captive insures unrelated risks (including brother-sister transactions), it appears that the Service's ability to challenge those transactions following Americo, Harper Group, Sears, and Humana has been severely limited.

As discussed above, the cases involve three distinct forms of captive insurance transactions: (1) captive insures only its parent and other related parties; (2) captive insures its parent and unrelated parties; and (3) captive insures its sibling subsidiaries (brother-sister captive insurance). Under scenario (1), premiums paid by the parent are never deductible. On the other hand, cases involving scenarios (2) and (3) hold that the premiums are generally deductible unless there are other "stinky" facts present besides the mere fact that the insurer and insureds are related.

In this case, it appears that [redacted]'s facts fall into scenarios ([redacted]) and ([redacted]). Although Rev. Rul. 2001-31 does not announce that the Service will throw in the towel whenever it is faced with a brother-sister transaction or evidence of unrelated party insurance, cases involving those facts are unlikely to be litigated without a showing of additional abusive facts. Generally, the more the captive resembles a commercial insurance company, and the more the transaction resembles an arm's-length commercial transaction, the less likely the transaction will be considered to be abusive. It is, therefore, necessary that you engage in further factual development to distinguish the facts in this case from those in which the courts have found the requisite risk shifting and risk distributing.

The following are some additional factors you may want to consider in your factual development:

, (b)(5)(AC),

[redacted]

, (b)(5)(AC),

[redacted]

, (b)(5)(AC) [redacted]

, (b)(5)(AC) [redacted]

See Black Hills Corp. v. Commissioner, 73 F.3d 799 (8th Cir. 1996) (taxpayer required to capitalize front-loaded payment of premiums attributable to coverage in subsequent years). The premiums for each year's policy must be commensurate with the risk insured by that policy.

As previously noted, this memorandum constitutes preliminary advice intended to assist you in developing the facts in this case. Once you have fully developed the facts, please contact this office so that we can provide additional advice regarding whether adjustments to the parent's claimed insurance deductions are warranted.

Please call the undersigned at (860) 290-4077 if you have any questions or require further assistance.

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(Signed) Carmino J. Santaniello

By:__________________________________
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